

Message Text

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TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
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DEPARTMENT PASS FEDERAL RESERVE BOARD

TREASURY FOR DONALD E. SYVRUD, OASIA

E.O. 11652: N/A
TAGS: EFIN, UK
SUBJECT: UK ECONOMIC FORECAST TO MID-1979

SUMMARY AND INTRODUCTION:
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THIS WILL BE A YEAR OF ECONOMIC PROGRESS, FOLLOWING
ON THE SUBSTANTIAL FINANCIAL IMPROVEMENT REGISTERED IN
1977. BETTER ECONOMIC PERFORMANCE WILL BE RECORDED IN
1978 OVER A WIDE RANGE OF INDICATORS, BUT MUCH OF REAL
PROGRESS MADE WILL BE ERODED GRADUALLY DURING 1979.
LOOKING TO MID-1979, A KEY QUESTION IS HOW MUCH OF THE

ECONOMIC IMPROVEMENT CAN BE RETAINED. THE RESULTS OF THE NEXT WAGE ROUND, AS YET UNKNOWN, WILL HAVE A MAJOR IMPACT IN DETERMINING THE ANSWER, BUT SO TOO WILL THE RESULTS OF MONETARY AND FISCAL POLICY.

THERE IS A GENERAL EXPECTATION THAT OCTOBER WILL SEE A GENERAL ELECTION. SUBJECT TO CAVEATS, WE DO NOT BELIEVE THE ELECTION OUTCOME WILL INFLUENCE REAL ECONOMIC PERFORMANCE DURING THE PERIOD COVERED BY THIS FORECAST. THE CAVEATS INCLUDE DAMAGE TO BUSINESS CONFIDENCE FROM STATEMENTS THAT MIGHT APPEAR IN PARTY MANIFESTOS, POTENTIAL NEGATIVE PSYCHOLOGICAL EFFECT OF ELECTIONEERING ON THE FINANCIAL (I.E., GILT AND MONEY) MARKETS, COUPLED WITH A VIEW HEARD IN FOREIGN EXCHANGE MARKETS THAT NEITHER MAJOR PARTY IS OFFERING ATTRACTIVE ECONOMIC POLICIES; AND, FINALLY, THE POSSIBILITY THAT A CONSERVATIVE-THATCHER VICTORY WOULD RAPIDLY LEAD TO CONFRONTATION WITH THE UNIONS A LA HEATH IN THE WINTER OF 1973. WE HAVE NOT BUILT THESE INTO THE FORECAST, DO NOT SUGGEST THEY WILL HAPPEN, BUT EQUALLY CANNOT IGNORE RAISING THE POSSIBILITY THAT THEY MIGHT.

WHAT IS MORE CERTAIN IN 1978 IS REAL GROWTH OF GDP IN THE RANGE OF 3 PERCENT, AFTER MINIMAL GROWTH IN 1977, FUELED BY RISING REAL INCOME AND A MINI-CONSUMER BOOM, RESPECTABLE GROWTH TO MANUFACTURING INVESTMENT, AND AN LIMITED OFFICIAL USE

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IMPROVEMENT IN MANUFACTURING AND INDUSTRIAL PRODUCTION. GOVERNMENT EXPENDITURE, AFTER DECLINING SLIGHTLY IN 1977, WILL RISE SOMEWHAT. IN THE IMPROVED CLIMATE, SHOULD CONSUMERS DECIDE NOT TO REBUILD REAL ASSET BALANCES BUT INSTEAD REDUCE SAVINGS, THE ECONOMY WOULD RECEIVE A FURTHER FILLIP.

THE BALANCE OF PAYMENTS ON CURRENT ACCOUNT WILL AGAIN BE IN ROUGH BALANCE, AS RISING IMPORTS OF BOTH MANUFACTURED PRODUCTS AND CONSUMER GOODS AND SERVICES WORK TO OFFSET THE INCREASING BENEFITS OF NORTH SEA OIL.

INFLATION THIS YEAR WILL BE REDUCED TO 9 PERCENT, FROM 16 PERCENT LAST YEAR, BUT THE ANNUAL RATES OF 7.5-8 PERCENT CURRENTLY BEING RECORDED WILL MARK A LOW, WITH PRICES BEGINNING TO RISE AT THE RETAIL LEVEL IN THE FALL, EVENTUALLY RETURNING TO DOUBLE FIGURES. GOVERNMENT ACTIONS UP UNTIL THE ELECTION (WHENEVER IT IS HELD) WILL BE DESIGNED TO MINIMIZE OR MASK PRICE INCREASES. EXAMPLES INCLUDE THE 2.5 PERCENTAGE POINT INCREASE IN THE EMPLOYERS' CONTRIBUTION TO NATIONAL INSURANCE, TO BEGIN OCTOBER 2, RATHER THAN AN IMMEDIATE

INCREASE IN VAT TO FINANCE DIRECT TAX CUTS FORCED ON THE
GOVERNMENT.

IN ADDITION, THE BANK OF ENGLAND CAN BE EXPECTED TO
DO ITS BEST TO KEEP STERLING STEADY EVEN AT A SUBSTANTIAL

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COST TO THE RESERVES, BUT WILL ALLOW SOME FURTHER DEPREE-
CIATION TO OFFSET AT LEAST PARTIALLY THE INFLATION
DIFFERENTIAL BETWEEN THE U.K. AND ITS MAJOR TRADING PART-
NERS. THIS SAID, THE TRADE WEIGHTED FALL IN THE POUND
THUS FAR IN 1978, THE RISE IN THE WHOLESALE PRICE INDICES,
AND THE EXPECTATION OF AVERAGE EARNINGS INCREASING
14-15 PERCENT THIS YEAR AND 10-12 PERCENT THROUGH MID-
1979 ADUMBRATE RISES IN RETAIL PRICES AS THEY WORK
THROUGH THE SYSTEM.

THE RECENT MINI-BUDGET MEASURES, CLAWING BACK OF

OPPOSITION-IMPOSED TAX CONCESSIONS, REIMPOSITION OF
RESTRAINT ON BANK LENDING AND INCREASE IN MLR, WERE
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SEEN AS NECESSARY IF A DEGREE OF CONFIDENCE WAS TO BE
RESTORED IN MARKETS. THE FINANCIAL MARKETS HAVE
REACTED POSITIVELY TO THE GOVERNMENT'S APPARENT DEDICA-
TION TO ACHIEVE THIS YEAR'S MONETARY AND PSBR TARGETS.
(PERHAPS A NECESSITY IF STERLING IS TO AVOID COMING
UNDER PRESSURE IN THE FOREIGN EXCHANGE MARKETS.) A
DIFFICULTY IS THAT THE MARKETS ARE NOT IMPRESSED WITH
THE TARGETS THEMSELVES. (LAST FISCAL YEAR, PSBR WAS
5.7 BILLION POUNDS, THE M-3 GROWTH TARGET WAS 9-13
PERCENT--THE EVENTUAL OUTCOME BEING 16.5 PERCENT; THIS
FISCAL YEAR'S PSBR FORECAST IS 8.5 BILLION POUNDS, WITH
AN M-3 GROWTH TARGET OF 8-12 PERCENT.)

DESPITE THE RECENT MEASURES, THE MARKET REMAINS
SKEPTICAL THAT THE GOVERNMENT WILL BE ABLE TO MEET THE
TARGETS DURING THE ENTIRE FISCAL YEAR. THE TARGETS
ARE GENERALLY SEEN AS BEING AT THE OUTER LIMITS OF
PRUDENCE. IMPOSITION OF CREDIT RESTRAINT AND HIGHER
INTEREST RATES MAY BE SUFFICIENT TO INSURE THAT
SUFFICIENT GILTS ARE SOLD TO AVOID AN INCREASE IN THE
MONEY SUPPLY ABOVE THE TARGET. THE PRICE, HOWEVER,
MAY BE CROWDING OUT, REDUCED PRIVATE INVESTMENT,
AND A RELATIVE REDUCTION IN THE RATE OF ECONOMIC GROWTH.

BECAUSE SO MUCH OF WHAT HAPPENS THIS YEAR DEPENDS ON
CONSUMER REACTION, IT IS MUCH MORE DIFFICULT, FROM 1979
ONWARDS, TO ASSESS THE SHORT-TERM DETERMINANTS OF DOMES-
TIC ECONOMIC GROWTH. WE HAVE, THEREFORE, TAKEN A
CAUTIOUS APPROACH IN OUR FORECAST OF THE FIRST HALF OF
NEXT YEAR. NOR, AT THE MOMENT, IS THERE MUCH EVIDENCE
THAT THE U.K. IS MAKING MEANINGFUL PROGRESS IN DEALING
WITH ITS LONGER TERM STRUCTURAL PROBLEMS; I.E., HIGH
IMPORT PROPENSITIES; LOW GROWTH, PROFITS, AND INVESTMENT;
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TRADE UNION POWER; CLASS DIFFERENCES; POOR MANAGEMENT
PRACTICES FOCUSING ON SHORT-TERM CONSIDERATIONS;
PREFERENCE BY UNIVERSITY GRADUATES FOR EMPLOYMENT IN
THE PROFESSIONS AND CIVIL SERVICE OVER MANUFACTURING
INDUSTRY; DIRECT AND INEFFICIENT GOVERNMENT INVOLVEMENT
IN INDUSTRIES NOTED FOR OVERMANNING AND LOW PRODUCTIVITY.
THESE PROBLEMS ARE IDENTIFIED BUT SOLUTIONS REMAIN TO BE

FOUND.

1. AVERAGE EARNINGS ARE A MAJOR DETERMINANT OVER THE PAST THREE YEARS THE U.K. ECONOMY HAS MOVED FROM SEVERE CRISIS TO RELATIVE STABILIZATION AND FINANCIAL RECOVERY AND LATELY TO A CONSUMER-LED REBOUND IN REAL GROWTH. THE OVERRIDING UNCERTAINTY IN THE YEAR TO MID-1979 IS THE DURABILITY OF THE CURRENT UPTURN. POLITICALLY MOTIVATED INCREASES IN PUBLIC EXPENDITURE AND REDUCTIONS IN PERSONAL INCOME TAXATION WILL PUSH GDP ABOVE SUSTAINABLE GROWTH RATES. HOW LONG THE ECONOMY OVERSHOOTS A SUSTAINABLE RATE OF GROWTH DEPENDS, INTER ALIA, ON FISCAL AND MONETARY POLICY AND THE RATE OF INCREASE IN AVERAGE EARNINGS DURING THE 12-MONTH WAGE ROUND BEGINNING AUGUST 1, 1978. SINCE WAGES AND SALARIES MAKE UP THE LARGEST COMPONENT OF INDUSTRIAL COSTS AND PERSONAL INCOMES, A FAILURE TO REDUCE THEIR RATE OF GROWTH FROM THE PROBABLE 14-15 PERCENT IN THE CURRENT PAY-ROUND WILL RESULT IN A RESURGENCE OF INFLATION LATER THIS YEAR AND NEXT. (COUPLED WITH THE FALL IN STERLING IN THE FIRST HALF OF THIS YEAR, THE RESULT WILL BE DOUBLE-DIGIT INFLATION BY EARLY NEXT YEAR.)

THE ENVIRONMENT FOR ACHIEVING SOME DECELERATION IN THE RATE OF INCREASE IN AVERAGE EARNINGS IN THE ABSENCE OF A RIGID INCOMES POLICY MAY BE MORE FAVORABLE THAN AT ANY TIME SINCE WAGE RESTRAINT WAS FORMALLY REINTRODUCED IN AUGUST 1975. BY OVERSHOOTING THE LIMITED OFFICIAL USE

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GOVERNMENT 10 PERCENT TARGET, THE CURRENT PAY ROUND MAY HAVE EASED THE WORST ANOMALIES OF THE PREVIOUS TWO

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YEARS. MOREOVER, THE COMING WAGE ROUND WILL GET UNDER WAY LATE THIS SUMMER AGAINST A BACKGROUND OF SINGLE DIGIT INFLATION, SHARPLY HIGHER REAL DISPOSABLE INCOMES, A VISIBLE DESIRE ON THE PART OF MOST TRADE UNION LEADERS TO COOPERATE WITH THE GOVERNMENT ON WAGES, AND THE CHASTENING EFFECT OF A GENERAL ELECTION, INCREASINGLY PROBABLE IN OCTOBER. WHILE IT IS UNLIKELY THAT HMG CAN DEVISE A POLICY LIKELY TO HOLD THE RISE IN EARNINGS TO ANYTHING LIKE THE 7-8 PERCENT TARGET IT HAS HINTED AT, A RISE OF 10-12 PERCENT IS NOT BEYOND THE REALM OF REASON. ACHIEVING SUCH A FIGURE WOULD IMPLY CONTINUING GOVERNMENT FIRMNESS IN THE PUBLIC SECTOR COUPLED WITH A WILLINGNESS BY THE PRIVATE SECTOR TO RESIST POTENTIAL

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TIALLY LARGE INDIVIDUAL PAY CLAIMS IN THE WAKE OF A RAPID RISE IN THE RATE OF ECONOMIC ACTIVITY DURING THE SECOND HALF OF 1978.

2. GDP

GDP, AFTER SLIGHT GROWTH (0.3 PERCENT IN 1977 EXPENDITURE BASIS), WILL GROW ROUGHLY 3 PERCENT THIS YEAR, THEN DROP TO SLIGHTLY OVER 2 PERCENT IN THE FIRST HALF OF 1979. ON THE ASSUMPTIONS OF 10-12 PERCENT AVERAGE EARNINGS IN THE PAY ROUND BEGINNING IN AUGUST AND LITTLE FURTHER CHANGE IN THE TRADE-WEIGHTED VALUE OF STERLING BEFORE OCTOBER 1978, IT SEEMS HIGHLY LIKELY THAT THE U.K. ECONOMY WILL GATHER STEAM THROUGH 1978, THE GROWTH RATE EASING OFF DURING THE FIRST HALF OF

1979 AS REAL INCOMES STOP RISING IN THE FACE OF ACCELERATING PRICES.

3. CONSUMPTION

CONSUMER EXPENDITURE WILL BE THE PRIMARY ENGINE OF GROWTH. REAL PRE-TAX EARNINGS ARE LIKELY TO RISE BY 3.0 PERCENT IN 1978. TO THIS MUST BE ADDED SIMILAR RISES IN TRANSFER PAYMENTS. INCOME TAX CUTS ANNOUNCED IN THE APRIL BUDGET, COUPLED WITH THE FURTHER CUTS APPENDED TO THE FINANCE BILL IN COMMITTEE, ARE LIKELY TO BRING THE OVERALL RISE IN REAL DISPOSABLE INCOME TO ABOUT 5 PERCENT. THERE WILL BE SOME EROSION IN THE RATE OF INCREASE IN REAL INCOMES DURING THE FIRST HALF OF 1979 AND A CONCOMITANT SLOWING IN CONSUMER EXPENDITURE. ASSUMING LITTLE CHANGE IN THE SAVINGS RATIO, CONSUMER EXPENDITURE IS LIKELY TO RISE BY THE FULL AMOUNT OF THE CHANGE IN DISPOSABLE INCOME. ANY DOWNWARD VARIATION IN THE SAVINGS RATIO WILL ADD TO THAT FIGURE.

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4. INVESTMENT AND GOVERNMENT EXPENDITURE

DESPITE A FIRST QUARTER DECLINE IN MANUFACTURING INVESTMENT, OVERALL FIXED CAPITAL FORMATION SHOULD RISE THROUGH 1978 AND INTO 1979. IN 1978, PRIVATE SECTOR INVESTMENT SHOULD AT LEAST MATCH ITS 4.4 PERCENT 1977 RISE WHILE PUBLIC INVESTMENT IS SCHEDULED TO DECLINE BY JUST 3.0 PERCENT AFTER DECLINING BY 19.8 PERCENT IN 1977. HOWEVER, PUBLIC INVESTMENT IS PLANNED TO RISE AT AN ANNUAL RATE OF 12.5 PERCENT DURING THE FIRST HALF OF 1979. GOVERNMENT EXPENDITURE ON CURRENT GOODS AND SERVICES IS SCHEDULED TO RISE BY 2.3 PERCENT, A FIGURE THAT LOOKS LOW IN LIGHT OF A RECENT REMARK BY THE CHANCELLOR THAT A 5 PERCENT INCREASE IN FY-78/79 LOOKED THE MOST LIKELY OUTCOME.

5. INDUSTRIAL PRODUCTION

THE ABILITY OF U.K. INDUSTRY TO RESPOND TO RISING CONSUMER DEMAND IN 1978 WILL BE REFLECTED IN THE RATE OF RETAIL PRICE INCREASE, THE LEVEL OF UNEMPLOYMENT AND THE MOVEMENT IN THE CURRENT ACCOUNT. WHILE THERE IS UNDOUBTEDLY A MARGIN OF UNUSED CAPACITY IN THE FORM OF IDLE PLANT AND LABOR, THIS MARGIN MAY BE SMALLER THAN INDICATED BY TRADITIONAL CAPITAL-OUTPUT RATIOS AND SIMPLE TECHNIQUES OF EXTRAPOLATION. SPOT SHORTAGES IN KEY SKILLS, THE SHARP DECLINE IN FIXED INVESTMENT SINCE 1973, AND THE CHANGE IN THE RELATIVE PRICE OF ENERGY ALL DETRACT FROM THE SHORT RUN RESPONSIVENESS OF INDUSTRIAL PRODUCTION.

WITH ALL THAT AS A CAVEAT, IT SHOULD BE NOTED THAT INDUSTRIAL PRODUCTION HAS RISEN AT AN ANNUAL RATE OF 5.5

PERCENT IN THE 6 MONTHS TO APRIL 1978. THIS IS THE LONG-
EST SUSTAINED INCREASE IN OUTPUT SINCE THE OIL CRISIS.
YET ONLY JUST OVER HALF OF THIS RISE CAME FROM THE TRA-
DITIONAL ENGINEERING CORE OF BRITISH INDUSTRY, THE REMAIN-
DER FROM NORTH SEA OIL PRODUCTION AND A WEATHER RE-
LATED RISE IN GAS AND ELECTRICITY OUTPUT. THIS INDICATES

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THAT THERE IS ROOM FOR PRODUCTION TO EXPAND AT A MORE
RAPID PACE (PERHAPS 8.0 PERCENT AT AN ANNUAL RATE) DURING
THE SECOND HALF OF 1978. HOWEVER, SUCH A PACE WOULD NOT
BE SUSTAINABLE FOR MORE THAN A FEW QUARTERS.

6. EMPLOYMENT

THE IMPLICATIONS OF THE PATTERNS OF OUTPUT DESCRIBED IN THIS MESSAGE FOR BOTH THE LEVEL OF EMPLOYMENT AND UNEMPLOYMENT ARE LESS THAN AUSPICIOUS. DURING THE PAST 3 YEARS, A VARIETY OF GOVERNMENT PROGRAMS HAS MADE IT WORTHWHILE TO RETAIN AS MANY AS 300,000 PEOPLE IN EMPLOYMENT. MOREOVER, RECENT EMPLOYMENT PROTECTION LEGISLATION HAS MADE IT FAR MORE DIFFICULT AND EXPENSIVE TO LAY OFF

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WORKERS. AS A RESULT, THE RISE IN AGGREGATE DEMAND IS NOT LIKELY TO BE REFLECTED IN SHARP CHANGES IN THE LEVELS OF EMPLOYMENT OR UNEMPLOYMENT. WHILE SEASONALLY ADJUSTED UNEMPLOYMENT FELL FROM 6.0 TO 5.7 PERCENT BETWEEN DECEMBER 1977 AND JUNE 1978, EMPLOYMENT IN PRODUCTION INDUSTRIES SHOWED VIRTUALLY NO CHANGE DURING THE FIRST QUARTER OF THE YEAR. THE EXPECTED SECOND HALF SURGE IN GROWTH MAY PARE UNEMPLOYMENT TOTALS AT THE MARGIN, BUT EMPLOYMENT IS UNLIKELY TO SHOW MUCH CHANGE.

7. PRICES

THE 12-MONTH RATES OF INCREASE OF BOTH RETAIL AND WHOLESALE PRICES OF FINISHED GOODS ARE SHOWING SIGNS OF LEVELLING OUT AT ABOUT 8 PERCENT FOLLOWING A YEAR OF SHARP DECLINES. IN THE WAKE OF SURGING AGGREGATE DEMAND, THE MONTHLY RATES OF PRICE INCREASE SHOULD MOVE BACK INTO THE 1 PERCENT RANGE DURING THE 4TH QUARTER OF 1978 REMAINING THERE THROUGH THE BEGINNING OF 1979 WHEN THE IMPACT OF CURRENT WAGE SETTLEMENTS BEGINS TO BE FELT. GIVEN THE ASSUMPTIONS ON PAY INCREASES AND STERLING, THE RISE IN REAL PRE-TAX EARNINGS SHOULD BE CHOKED BACK DURING THE FIRST HALF OF 1979, THE CHANGE IN CONSUMER DEMAND SHOULD BEGIN TO BE REFLECTED IN SMALLER RISES IN RETAIL PRICES IN THE SECOND HALF OF 1979 THAN IN THE FIRST HALF.

8. THE BALANCE OF PAYMENTS

THE CURRENT ACCOUNT POSITION THROUGH THE FIRST SEMESTER OF 1979 (1979-I) WILL REFLECT DIVERSE COUNTERPOSED FORCES WHICH SHOULD, ON A NET BASIS, HINDER THE EMERGENCE OF A SUBSTANTIAL SURPLUS. THE ATYPICAL STRONG GROWTH IN THE U.K.'S REAL OUTPUT AND AN INFLATION RATE EXCEEDING ITS INDUSTRIAL TRADING PARTNERS' OUGHT TO ERODE THE NON-OIL TRADE BALANCE. THE GOVERNMENT'S EXCHANGE RATE POLICY

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MUST NATURALLY REFLECT ITS VIEW OF HOW IT WISHES THE U.K. EXTERNAL PORTFOLIO TO BE RESTRUCTURED, AND THE BOUNDS THAT THE MARKET WILL IMPOSE ON EFFECTING THAT POLICY.

THE FORECAST ASSUMES THAT THE TRADE-WEIGHTED INDEX OF STERLING WILL BE ALLOWED TO DEPRECIATE BY AT LEAST AN AMOUNT SUFFICIENT TO KEEP THE CURRENT ACCOUNT OUT OF DEFICIT. THUS A POSITIVE INFLOW OF CAPITAL WILL BE REQUIRED IF THE PUBLIC SECTOR'S NET EXTERNAL POSITION IS TO IMPROVE AND TO ALLOW DEBT REPAYMENT WITHOUT DRAWING DOWN RESERVES. THE U.K. MAY BE FORCED SIMPLY TO RESTRUCTURE ITS OUTSTANDING OBLIGATIONS, BORROWING MEDIUM OR LONG-TERM FUNDS TO REPAY SOME OF THE DEBT (REPAYMENTS PEAK IN 1980-1982). GIVEN THE CURRENT FAVORABLE CLIMATE FOR SYNDICATED BANK LOANS TO SOVEREIGN RISK BORROWERS, SOME BANKERS EXPECT THE U.K. TO ENTER THE MARKET THIS YEAR TO BENEFIT FROM THE NARROW SPREADS AND LONGER MATURITIES AVAILABLE.

OIL PRODUCTION CAN BE EXPECTED TO BE IN THE RANGE OF 60 MILLION TONS IN 1978 AND UP TO 80 MILLION TONS IN 1979 (OR ABOUT 37.8 MILLION TONS IN THE FIRST HALF). WE ASSUME THAT A 2 PERCENT INCREASE IN ENERGY CONSUMPTION WILL BE SATISFIED BY EQUAL INCREASES IN PETROLEUM AND NATURAL GAS CONSUMPTION, AS WELL AS A SMALL INCREASE FROM NUCLEAR-POWERED GENERATING PLANTS.

IN 1978 A LOSS IN COMPETITIVENESS, SLOW GROWTH IN EUROPE AND IMPROVING GROWTH IN THE U.K. SHOULD SHARPLY REDUCE THE SURPLUS IN THE NON-OIL TRADE ACCOUNTS. AS NOTED, REAL GDP IS EXPECTED TO RISE ABOUT 3 PERCENT AND WHOLESALE PRICES 9.0 PERCENT. THE RATE OF GROWTH OF OUTPUT AND PRICES SHOULD RISE TOWARD THE END OF 1978. IN THE PERIOD APPROXIMATELY BETWEEN THE MIDDLE OF 1978 AND THE MIDDLE OF THE FIRST HALF OF 1979, OUTPUT SHOULD BE GROWING AT ROUGHLY A 3 PERCENT ANNUALIZED RATE AND PRICES AT 11.5 TO 12 PERCENT. IN ASSESSING THE U.K. EXTERNAL OUTLOOK, WE ASSUME IN THE FORECAST PERIOD THAT EC INDUSTRIAL PRODUCTION INCREASES 3.0 PERCENT AND CON-

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SUMER PRICES 7.5 PERCENT.

SERVICES IN 1978 WILL CONTINUE THE DECLINE FIRST NO-

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TICED IN 1977. THIS IS ATTRIBUTABLE TO A NUMBER OF FACTORS, AMONG WHICH ARE INCREASED NORTH SEA OIL INCOME TO NON-RESIDENT COMPANIES, DECELERATING NET TOURIST RECEIPTS BECAUSE OF GROWING U.K. INCOME AND DECLINING RELATIVE COMPETITIVENESS, AND INCREASED NET TRANSFERS TO THE EC.

WE ASSUME THE TRADE-WEIGHTED INDEX OF STERLING IS SLIGHTLY LESS ON AVERAGE FOR 1978 THAN IT WAS IN 1977 (I.E., 62.5)

AS THE TRADE-WEIGHTED INDEX OF STERLING DECLINES OVER 1979, AVERAGING ABOUT 60.0 FOR THE YEAR AS A WHOLE, PART OF THE LOSS IN COMPETITIVENESS DUE TO UNEQUAL GROWTH IN PRICES WILL BE OFFSET BY EXCHANGE RATE DEPRECIATION. SUCH A DEPRECIATION WOULD BE SUFFICIENT TO KEEP THE CURRENT LIMITED OFFICIAL USE

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RENT ACCOUNT OUT OF DEFICIT FOR THE FIRST SEMESTER OF 1979. UNDER THESE CIRCUMSTANCES EXPORTS SHOULD GROW AT AN ANNUAL RATE OF SLIGHTLY OVER 3.0 PERCENT AND IMPORTS AT A RATE OF 6.5 PERCENT. THE INVISIBLE BALANCE MORE-OVER OUGHT TO IMPROVE A LITTLE IN 1979, IN PART AS THE RATE OF GROWTH OF INVESTMENT INCOME OUTFLOWS DECLINES. ON THIS BASIS, THE LIKELY OUTCOME FOR THE BALANCE OF

PAYMENTS WILL BE AS FOLLOWS:

(MILLIONS OF POUNDS)

	1977	1978	1979-I	
OIL EXPORTS		1,965	2,500	1,510
OIL IMPORTS		- 4,769	- 4,070	- 1,980
BALANCE OF TRADE ON				
PETROLEUM PRODUCTS		- 2,804	- 1,570	- 470
NON-OIL EXPORTS		30,211	33,100	18,240
NON-OIL IMPORTS		-29,019	-32,900	-18,420
BALANCE ON NON-				
OIL TRADE		1,192	200	- 230
VISIBLE BALANCE		- 1,612	- 1,370	- 700
BALANCE ON INVISIBLES		1,777	1,450	800
TOTALS		165	80	100

9. THE GENERAL OUTLOOK

SUBJECT TO ALL THE USUAL CAVEATS

-- AND THE MARGINS OF ERROR IN THIS FORECAST (ES-
 PECIALLY FOR 1979) ARE GREATER THAN USUAL -- OUR BEST ES-
 TIMATE OF THE OUTCOME FOR THE MAIN ELEMENTS IN THE ECON-
 OMY THROUGH MID-1979 ARE AS FOLLOWS:

(PERCENT CHANGE, ANNUAL RATE)

	78-I	78-II	79-I	
	1977	77-II	78-I	1978 78-II
GDP	0.3	2.4	5.6	2.8 2.1
CONSUMPTION	-0.8	6.9	5.1	5.7 2.4
FIXED INVESTMENT	-3.8	-2.5	8.4	1.4 4.2

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MFG. INVESTMENT	7.9	0.4	19.1	8.6	10.0
INVENTORY CHANGE(1)	0.9	1.1	0.6	0.8	1.5
GOVT. EXPENDITURE	-0.2	2.9	4.5	2.7	3.5
VISIBLE TRADE(2)	-1.6	-0.6	-0.8	-1.4	-0.7
INVISIBLE TRADE (2)	1.8	0.7	0.8	1.5	0.8
CURRENT ACCOUNT (2)	0.2	0.1	0.0	0.1	0.1
INDUSTRIAL PRODUCTION	1.5	3.0	8.0	3.5	3.0
UNEMPLOYMENT RATE(3)	6.0	5.7	5.3	5.3	5.7
RETAIL PRICE	15.8	7.7	10.0	8.8	12.0
WHOLESALE PRICE	19.2	8.8	10.1	9.0	12.5

(1) - AS A PERCENT OF GDP; (2) - BILLIONS OF POUNDS;

(3) - FOR DECEMBER - JUNE.

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ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 SP-02 ICA-11 AID-05
EB-08 NSC-05 SS-15 STR-07 OMB-01 CEA-01 CIAE-00
COME-00 FRB-03 INR-10 NSAE-00 XMB-02 OPIC-03
LAB-04 SIL-01 L-03 H-01 PA-01 AGRE-00 /119 W
-----031372 231925Z /43

R 231555Z JUN 78
FM AMEMBASSY LONDON
TO SECSTATE WASHDC 7481
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY OTTAWA
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY TOKYO
AMEMBASSY BRUSSELS
USMISSION GENEVA

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10. A TECHNICAL NOTE ON THE BALANCE OF PAYMENTS FORECAST
MOST SERIOUS FORECASTERS OF THE CURRENT ACCOUNT
HAVE ENCOUNTERED TECHNICAL PROBLEMS OVER THE MOST RECENT
PAST. AMONG OTHER THINGS, IT IS WIDELY SPECULATED THAT
LENGTHS OF THE LAGS ON SUBCOMPONENTS OF TRADE VOLUME
HAVE DECLINED. OVER SHORT PERIODS OF TIME, IN FACT, THE
LAGS APPEAR SHORTER THAN A PRIORI KNOWLEDGE, E.G., OF
ORDER-LEAD TIMES, MAKE PLAUSIBLE. AT THE SAME TIME,
THE ESTIMATION OVER VERY SHORT TIME PERIODS IS NOT
ONLY HAZARDOUS, BUT DIFFICULT IN THE FACE OF LIMITED
VARIATION IN CERTAIN KEY VARIABLES, E.G., REAL GDP.

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IN PREPARING THIS FORECAST, LACKING ADEQUATE
COMPUTATIONAL ASSISTANCE, USE WAS MADE OF CONSTANT
PARTIAL ELASTICITIES (OR SHARES) ACTING WITHIN THE
SEMESTER. THAT IS, THE GROWTH IN A FUNCTION, SAY NON-
OIL EXPORT VOLUME, IS EQUAL TO THE SUM OVER J OF N(J)
TIMES THE GROWTH IN THE JTH VARIABLE. N(J), THE
PARTIAL ELASTICITY OR SHARE, IS DEFINED AS THE PRODUCT

OF THE PARTIAL DERIVATIVE OF THE FUNCTION WITH RESPECT
TO THE JTH VARIABLE TIMES THE VALUE OF THE JTH VARIABLE
DIVIDED BY THE VALUE OF THE FUNCTION. THESE PARTIAL
ELASTICITIES ARE ROUGHLY:

	U.K.	EEC	INDUSTRIAL	COMPETI-
	REAL GDP	PRODUCTION	TIVENESS	
NON-OIL IMPORT VOLUME	1.75	--		0.5
NON-OIL EXPORT VOLUME	--	1.1		-0.2

BREWSTER

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 jan 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC REPORTS, ECONOMIC TRENDS
Control Number: n/a
Copy: SINGLE
Draft Date: 23 jun 1978
Decaption Date: 01 jan 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 20 Mar 2014
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
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Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Expiration:
Film Number: D780262-0981
Format: TEL
From: LONDON
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1978/newtext/t19780626/aaaaawkw.tel
Line Count: 720
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: d882a182-c288-dd11-92da-001cc4696bcc
Office: ACTION EUR
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
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Previous Handling Restrictions: n/a
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Review Release Date: N/A
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Review Withdrawn Fields: n/a
SAS ID: 2229134
Secure: OPEN
Status: NATIVE
Subject: UK ECONOMIC FORECAST TO MID-1979 . SUMMARY AND INTRODUCTION
TAGS: EFIN, UK
To: STATE TRSY
Type: TE
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